D.T.E. 02-40-C

Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service.

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I. INTRODUCTION

On June 21, 2002, the Department of Telecommunications and Energy ("Department") opened an investigation into all aspects of the manner in which default service is provided to ensure that it is compatible with the development of an efficient competitive market and to ensure that the benefits of a competitive market are available to all Massachusetts consumers at the end of the standard offer service transition period. Procurement of Default Service, D.T.E. 02-40, at 1 (2002). On April 24, 2003, the Department issued an Order addressing, among other things, the manner in which default service supply should be procured for medium and large commercial and industrial ("C&I") customers.[1] Procurement of Default Service, D.T.E. 02-40-B at 33-40 (2003).

In D.T.E. 02-40-B at 6-7, the Department stated that, in light of the active competitive market that has developed for medium and large C&I customers, default service for these customers "should function as a basic service that provides customers with the appropriate incentives to turn to the competitive market for more sophisticated or advantageous offerings. Larger customers should view default service as a short-term, last resort service, rather than a longer-term alternative to competitive supply." Currently, distribution companies procure default service supply for medium and large C&I customers through competitive solicitations

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[1] The following issues were also addressed in D.T.E. 02-40-B: (1) the cost components to be included in the calculation of default service rates; (2) the procurement of default service supply for residential and small C&I customers; and (3) the appropriate role of distribution companies in moving their customers toward competitive supply. The Department issued a previous Order addressing the effects of congestion costs and locational marginal pricing on the pricing and procurement of default service. Procurement of Default Service, D.T.E. 02-40-A (2003).

for terms of six months.[2] Pricing and Procurement of Default Service, D.T.E. 99-60-A at 6-9 (2000). Bidders are required to submit monthly prices for each month of the six-month term, with the bid prices submitted by the winning bidder(s) for each customer class forming the basis for the default service rates for that class. Id. Under the current procurement scheme, medium and large C&I customers know in advance the default service rates for each month of the procurement term.

In D.T.E. 02-40-B at 36-37, the Department recognized that under the current procurement scheme, default service customers are not receiving efficient price signals and are provided a level of price certainty more appropriately provided by the competitive market. The Department suggested an approach in which the supply procurement terms for medium and large C&I customers would be shortened to one month, stating:

> [a] persuasive, though not yet convincing, case can be made for the proposition that a procurement term of one month would (1) provide efficient price signals to customers because the resulting prices would track wholesale market price on a monthly basis; (2) provide customers with an appropriate level of price certainty; and (3) provide appropriate protection from spot market price volatility. Under this approach, distribution companies would procure their default service supply one month in advance, on an on-going basis (e.g., companies would procure supply for May 2003 during April 2003). Customers, in turn, would know the level of default service prices for only the next month. As discussed above, customers that seek greater price certainty could appropriately turn to the competitive market for these protections.

Id. at 39-40.

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[2] Pursuant to Pricing and Procurement of Default Service, D.T.E. 99-60-B at 1 (2000), distribution companies have the option to procure default service supply for up to twelve-month terms. However, since July 2002 all of the companies have opted for six-month procurement terms.

The Department held a technical session on May 15, 2003, to better understand the logistics associated with monthly procurements. Initial and reply comments were submitted on June 4 and 11, 2003, respectively by Associated Industries of Massachusetts ("AIM"); Cape Light Compact ("Compact"); James Cavicchi and Charles Augustine (jointly, "Cavicchi and Augustine"); Constellation Power Source, Inc., and Constellation New Energy, Inc., (jointly, ("Constellation"); the Commonwealth of Massachusetts Division of Energy of Energy Resources ("DOER"); Fitchburg Gas and Electric Light Company ("Fitchburg"); ISO New England ("ISO-NE"); Massachusetts Electric Company and Nantucket Electric Company (together, "MECo"); Boston Edison Company ("BECo"), Cambridge Electric Light Company ("Cambridge"), and Commonwealth Electric Company ("Commonwealth"), (together "NSTAR"); Select Energy ("Select"); Strategic Energy ("Strategic"); the Energy Consortium ("TEC"); Western Massachusetts Electric Company ("WMECo"); and the Western Massachusetts Industrial Customers Group ("WMICG").

II. SUMMARY OF COMMENTS

A. Introduction

There was broad agreement among most commenters that shortening the default service supply procurement for medium and large C&I customers from its current term of six months would provide more accurate price signals to customers (AIM Reply Comments at 1-2; Cavicchi and Augustine Comments at 4-6; Constellation Comments at 2; DOER Comments at 1-2; Fitchburg Comments at 1; ISO-NE Reply Comments at 1; NSTAR Comments at 3; Select Comments at 2; Strategic Comments at 3; WMECo Comments at 3-4). However, commenters disagree as to whether default service procurements should be shortened to quarterly or to one month terms.

B. Comments in Support of Quarterly Procurements

Fitchburg, MECo, NSTAR, Select, and WMECo support shortening the default service supply procurement term to three months, stating that quarterly procurements would achieve the goal of more accurate price signals for default service customers, while avoiding the logistical obstacles that would arise from monthly procurements (Fitchburg Comments at 2; MECo Comments at 1; NSTAR Comments at 3-4; Select Comments at 4; WMECo Comments at 4, 14). Fitchburg states that the more efficient price signals produced by quarterly solicitations, combined with the inclusion of bad-debt and administrative costs in default service rates, should encourage development of the competitive market (Fitchburg Comments at 2). WMECo adds that an immediate move from six-month to monthly procurements would be contrary to the Department's "measured approach" to structuring default service (WMECo Comments at 13).

Fitchburg, NSTAR, and WMECo allege that procuring default service supply on a monthly basis is incompatible with the multi-step process they currently use to procure supply (Fitchburg Comments at 2; NSTAR Comments at 4-7; WMECo Comments at 7-8). According to these commenters, the first step in the process is a detailed review of language to be included in the request for proposals ("RFP") and proposed supply contracts (NSTAR Comments at 4; WMECo Comments at 7). According to NSTAR and WMECo, preparation of the RFP and proposed supply contracts requires a thorough analysis of legal, regulatory and market issues in order protect the companies and their customers from changing conditions and costs in the wholesale market (NSTAR Comments at 5; WMECo Comments at 7). NSTAR allows ten business days for this detailed review (NSTAR Comments at 4).

The second step in the process is the issuance of the RFP and proposed contract, and the ensuing bidding period (NSTAR Comments at 4; WMECo Comments at 7). WMECo argues that four weeks is optimal to allow bidders sufficient time to prepare and submit bids, while NSTAR allows ten business days for this second step (NSTAR Comments at 4; WMECo Comments at 7). WMECo asserts that shortening the time available for suppliers to prepare bids could lessen market response to the solicitation, potentially resulting in higher prices (WMECo Comments at 8).

The third step of the solicitation process is a review and evaluation of bids by the distribution companies, including the filing of final pricing information by bidders (NSTAR Comments at 4; WMECo Comments at 7). NSTAR allows five business days for this step (NSTAR Comments at 4). The fourth step is the negotiation and finalization of supply contracts with the winning bidder(s) (NSTAR Comments at 4; WMECo Comments at 7). NSTAR identifies this as the most important step in the process, stating that "the negotiation of appropriate contracts to deal with the wide variety of issues that arise is a difficult and necessary undertaking. In addition to negotiating price terms during this process, liability issues, financial security provisions, and allocation of duties between the parties are each negotiated before a final contract is signed" (NSTAR Comments at 5). NSTAR allows ten business days for this fourth step, while WMECo typically allows no less than one week (NSTAR Comments at 4; WMECo Comments at 6).

The fifth and final step of the solicitation process is the filing by the distribution companies of default service supply contracts for Department review and approval. Pursuant to Procurement and Pricing of Default Service, D.T.E. 99-60-C at 8-9 (2000), the Department has five business days to review the results of the default service solicitation process. NSTAR states that the Department's review is necessary to confirm that distribution companies have procured supply contracts through a competitive process and that the costs incurred pursuant to those contracts are reasonable and appropriate (NSTAR Reply Comments at 3).

Fitchburg, NSTAR, and WMECo state that the implementation of monthly procurements would require distribution companies to compress the time required to administer the solicitation process in a way that would negatively effect their ability to obtain the most advantageous contract terms for default service customers (Fitchburg Comments at 2; NSTAR Comments at 4-7; WMECo Comments at 7-8). In addition, these commenters and Select argue that the implementation of monthly procurements will result in increased costs associated with administering the procurements and establishing the information technology ("IT") systems necessary to provide suppliers, on an ongoing and expedited basis, the default service load data needed to develop bids (Fitchburg Comments at 3; MECo Comments at 2; NSTAR Comments at 10-11; Select Comments at 2-3; WMECo Comments at 11-13). Conversely, NSTAR and WMECo argue that the implementation of quarterly procurements would (1) allow sufficient time to properly solicit for, negotiate, and seek Department approval of default service supply contracts while providing better price signals than those available under the current six-month schedule, and (2) avoid additional administrative and IT system costs (NSTAR Comments at 6-7, 10; WMECo Comments at 7-8).

MECo supports quarterly procurements, but specifies the revisions it would need to make to its solicitation process and IT system if the Department were to require monthly procurements. If required to implement monthly procurements, MECo would develop and use an "internet-based communication tool/website" to facilitate communications with bidders, and to allow bidders to submit complete and timely bids (MECo Comments at 2-3). According to MECo, its proposed automated system would frequently update default service-related customer and load data, allowing suppliers to refine their pricing models between bid submission dates (id.). MECo would post on the internet all information needed by suppliers to evaluate and price bids, including a schedule of critical dates associated with each month's procurement (id.).[3] MECo estimates that it would take eight months to develop the proposed system, at a cost of approximately $100,000, which it would request to recover from its ratepayers (id.).[4]

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3 MECo states that its solicitation schedule will attempt to finalize default service prices as close to the supply period as possible (MECo Comments at 2-3). MECo proposes to receive bids on the Tuesday that is at least two business days prior to the date that it will file its solicitation results with the Department (id.). MECo recommends that the Department require distribution companies to stagger their bid dates so that all default service load is not procured on the same day (id.).

4 These costs represent less than 0.2 percent of the $80 million in annual default service supply costs MECo incurs on behalf of its medium and large C&I customers (MECo Comments at 2).

MECo states that it would require each bidder to execute a "master contract or enabling agreement" prior to being permitted to submit a bid. Bidders proposing changes to the terms of the master contract could do so prior to the bid submission date (MECo Comments at 4). Fitchburg and NSTAR agree that standardized contracts would be required in any monthly procurement process (Fitchburg Comments at 2; NSTAR Comments at 6). However, NSTAR argues that evolving wholesale-market rules, including issues associated with the identification of newly designated congestion areas and the move from zonal to nodal locational pricing, could render any effort to develop standardized contracts "futile" at present (NSTAR Comments at 5-6). Until a standardized contract can be developed, NSTAR argues that the Department should allow distribution companies to implement quarterly procurement schedules (NSTAR Comments at 7).

Fitchburg, NSTAR, and WMECo identify two regulatory requirements that they allege impede the ability of distribution companies to finalize contracts with default service suppliers during the month preceding the supply month (Fitchburg Comments at 3; NSTAR Comments at 7-9; WMECo Comments at 5-7). First, pursuant to D.T.E. 99-60-C at 2-8, distribution companies are required to provide 30-days advance notice to their customers of changes in default service rates. NSTAR states that, if the Department were to retain the 30-day notification period, distribution companies would need to finalize supply contracts at least one month ahead of the supply month, thus diluting the accuracy of price signals (NSTAR Comments at 7-8). Conversely, if the Department were to reduce significantly the 30-day notification period, these commenters argue that default service customers would have insufficient opportunity to react to changes in monthly rates (Fitchburg Comments at 3; NSTAR Comments at 7-8; WMECo Comments at 5, n.3).

Second, ISO-NE's rules regarding the assignment of suppliers' installed capacity ("ICAP") obligations require that distribution companies provide ISO-NE with the identity of their default service suppliers approximately 25 days prior to effective date of the supply contract (NSTAR Comments at 8-9; WMECo Comments at 5). Thus, Fitchburg, NSTAR and WMECo argue that in order to satisfy the Department's 30-day notification requirement and the ISO-NE's ICAP reporting requirement, distribution companies must finalize supply contracts at least one month in advance (Fitchburg Comments at 3; NSTAR Comments at 8-9; WMECo Comments at 5-7.) Taking into account (1) the timeline of the distribution companies' solicitation processes, (2) the Department's 30-day notification requirement, and (3) the ISO-NE's ICAP requirement, WMECo states that a company would need to begin its default service solicitation process for May with the issuance of a RFP in February, resulting in an overlap of solicitations that could lead to confusion (WMECo Comments at 6). Conversely, NSTAR and WMECo argue that the implementation of a quarterly procurement schedule is consistent with the Department's customer notification requirements as well as the ISO-NE's ICAP requirement (NSTAR Comments at 8-9; WMECo Comments at 6-7).

Select states that, because of the substantial amount of work they must perform in responding to individual solicitations, suppliers are compelled to do a cost-benefit analysis to determine which procurement opportunities provide the highest potential benefit (Select Comments at 3-4). According to Select, suppliers must first obtain from the distribution company load data for each customer segment and then adjust the data for weather changes and load volatility. Second, suppliers must (1) solicit the market for supply, (2) price the available supply on a ISO-NE load-zone specific basis, and (3) line up hedging mechanisms. Third, suppliers must analyze and address any changes to the terms of the RFP or proposed supply contract. Finally, each bid is subject to internal management review (id.). Select asserts that the increased number of solicitations resulting from monthly procurements[5] would significantly increase suppliers' workload and would likely "put upward pressure on the already illiquid New England market" (id.). WMECo asserts that the implementation of monthly procurements will require simultaneous solicitations for all default service load in Massachusetts which could lead to gaming by wholesale suppliers (WMECo Comments at 10-11).

Several commenters argue that simultaneous monthly procurements by all of the distribution companies may present problems for the smaller companies, because suppliers may not have sufficient interest in serving smaller loads. This could result in decreased bids or failed auctions for smaller companies, potentially forcing the procurement of default service supply on the spot market (Fitchburg Comments at 2-3; NSTAR Comments at 9-10; Select Comments at 4; WMECo Comments at 9-10). Fitchburg recommends that the Department create an exemption from any monthly procurement requirement for smaller distribution

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5 According to Select, the number of Massachusetts default service supply procurements each year would increase from 42 to 182 if each distribution company procures default service supply for its medium and large C&I customer on a monthly basis (Select Comments at 3).

companies (Fitchburg Comments at 1, 3). Conversely, commenters argue that quarterly procurements with staggered schedules avoid the problems associated with smaller loads (NSTAR Comments at 10; WMECo Comments at 10-11).

Finally, WMECo claims that the short-term contractual arrangements associated with monthly procurements would (1) negatively effect the ability of distribution companies to comply with the renewable portfolio standards ("RPS"),[6] and (2) be inconsistent with the need of renewable resource developers for longer-term contracts (WMECo Comments at 8-9).

C. Comments in Support of Monthly Procurements

Cavicchi and Augustine, the Compact, Constellation, DOER, and Strategic support a one-month procurement term for default service supply, stating that monthly procurements will be a significant step towards crafting a default service that is consistent with the development of robust competitive markets (Cavicchi and Augustine Comments at 4-6;[7] Compact Comments at 3; Constellation Comments at 2; DOER Comments at 1; Strategic Comments at 3). Constellation states that monthly procurements will assure that default service prices do not

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6 WMECo states that it and the other distribution companies require default service suppliers to meet RPS requirements for the companies' loads. Under the data tracking system used to verify RPS compliance, verification does not take place for four to six months after a month's end. As a result, WMECo argues that monthly procurements may present RPS compliance problems in instances where a default service supplier is no longer doing business in Massachusetts (WMECo Comments at 9).

7 Cavicchi and Augustine state their concern, however, that the monthly procurement of default service may be "inconsistent with the long-term health of the wholesale market." They state that, if distribution companies are required to provide default service over an extended period of time, the Department will need to reevaluate its default service procurement policies (Cavicchi and Augustine Comments at 2).

deviate too far or too long from wholesale market conditions, thus reducing inefficient market behavior (Constellation Comments at 2). DOER asserts that quarterly procurements “fall well short” of the improvement that monthly default service procurements would have on competitive markets for medium and large C&I customers. DOER states that quarterly procurements would continue the “feast or famine” environment where customers are able to obtain price certainty and stability by returning to default service whenever competitive market conditions are less favorable than the six-month option (DOER Comments at 2; DOER Reply Comments at 3). The Compact states that procurement terms greater than one month will act as a barrier for municipal aggregation efforts (Compact Comments at 3). Strategic states that it would support quarterly procurements only as a transition to monthly procurements (Strategic Reply Comments at 13).

Constellation, DOER, and Strategic state that the risks suppliers bear are significantly less for a one-month procurement term than for a six-month term. These commenters argue there is a lessened likelihood of change in both regulatory conditions (i.e., changes in FERC or Department rules) and market conditions (i.e., changes in wholesale prices and default service loads) during a one-month contract term (Constellation Reply Comments at 2; DOER Comments at 3; Strategic Reply Comments at 3-4). Commenters argue that these reduced risks allow for the development of standardized procurement documents and processes for default service supply, permitting the distribution companies to conduct their procurement processes in a shorter time (Constellation Reply Comments at 2-3; DOER Comments at 3; Strategic Reply Comments at 3-4). Constellation and DOER emphasize the importance both of standardized agreements between distribution companies and suppliers and an automated procurement process (as proposed by MECo) in order to efficiently implement monthly procurements (Constellation Comments at 4-5; DOER Comments at 4; DOER Reply Comments at 2). In addition, Constellation and Strategic argue that ISO-NE's current ICAP market rules do not preclude a move to monthly procurements, as long as the procurements are scheduled in coordination with ISO-NE's monthly capacity auctions (Constellation Reply Comments at 3-4; Strategic Reply Comments at 6). Constellation cites the importance, in general, of establishing procurement schedules that are consistent with the schedule of other events known to effect wholesale prices (Constellation Comments at 5).

Citing the cost projections provided by MECo, Strategic argues that most of the increased costs associated with monthly procurements, such as IT system upgrades and the development of standardized contracts, are one-time costs that would be minimal compared to overall default service costs. The Compact and Strategic assert that standardization of the procurement process will reduce distribution companies' administrative costs (e.g., the need for the companies to conduct extensive contract negotiations), thus mitigating any increase in costs associated with hiring additional staff to conduct monthly procurements (Compact Comments at 3; Strategic Reply Comments at 6-8). DOER states that any increase in administrative costs caused by monthly procurements is outweighed by the benefits of enhanced competition, and should be offset by reduced supply costs resulting from decreased bid premiums for market uncertainty (DOER Comments at 3).

Strategic maintains that simultaneous monthly procurements may create a more liquid, competitive market, attracting more suppliers with increased bidding opportunities. Strategic states that MECo's proposal to stagger bid response dates would avoid simultaneous solicitations throughout Massachusetts (Strategic Reply Comments at 10-11). Similarly, Strategic suggests that monthly procurements may benefit smaller distribution companies because of the presence of more interested suppliers. Strategic argues that if there is insufficient interest from suppliers in serving smaller companies' loads, default service could be procured from the spot market, with the rate for the month based on an objective index of forward market prices (e.g., Platt's Megawatt Daily) (Strategic Reply Comments at 12-13). Constellation states that, if the Department concludes that Fitchburg's and WMECo's default service customers would be disadvantaged by monthly procurements, the Department could direct the companies to procure supply jointly, or exempt the companies from monthly procurements (Constellation Reply Comments at 3). Finally, DOER states that it is not convinced that the implementation of monthly procurements will result in lessened supplier interest in serving the default service loads of the smaller distribution companies, because the size of these companies' loads will not decrease, only the term of the supply contracts (DOER Comments at 5-6).

Constellation urges the Department to minimize the time lag between the submission of final binding prices by the bidders and the selection of a winning bidder, stating that the existing five-business day period for Department review is inconsistent with the "real time nature" of energy market pricing (Constellation Comments at 3-4). Constellation and DOER support a regulatory approval process where non-price terms and indicative prices are made available in advance for Department review, while final prices would be approved on the same day as submitted (Constellation Comments at 3-4; DOER Reply Comments at 3).[8] According to Constellation, this accelerated Department review would allow the winning bidder to execute hedging contracts the same day that its submits its final bid price, thus allowing the supplier "to properly manage market risk" (Constellation Comments at 3-4).

Similarly, DOER and Strategic recommend that the Department reduce the current 30-day notice period to further the objective of providing more accurate price signals to customers. These commenters state that any negative effects from a reduced notice period would be outweighed by the benefits of having default service rates that closely track wholesale prices (DOER Comments at 4; DOER Reply Comments at 4-5; Strategic Reply Comments at 5). Constellation and DOER emphasize the importance of informing and educating customers prior to the implementation of monthly procurements to minimize customer confusion (Constellation Reply Comments at 4-5; DOER Reply Comments at 5). DOER recognizes that smaller G2 customers (i.e., those customers whose demand is between 10 and 100 kilowatts) have limited competitive options at the present time, but urges the Department to proceed with monthly procurements for these customers, as well as for G3 customers (DOER Comments at 6-7). Finally, regarding renewable energy issues, Strategic argues that (1) RPS compliance for default service is a matter between distribution

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8 These commenters cite the state of Maine as an example where an accelerated regulatory approval process is used (Constellation Comments at 3-4; DOER Reply Comments at 3).

companies and suppliers and is outside the scope of this proceeding, and (2) long-term contracts should come from the competitive market and not from default service (Strategic Reply Comments at 8-9). Constellation adds that the monthly procurement of default service supply would not impede the ability of distribution companies to comply with their RPS requirements (Constellation Reply Comments at 4).

D. Other Comments

AIM, ISO-NE, and TEC, while supportive of the Department's objective of ensuring that default service rates accurately track wholesale market conditions, do not directly endorse either the quarterly or monthly procurement approach (AIM Reply Comments at 1-2; ISO-NE Reply Comments at 1; TEC Comments at 2-3). AIM states that it may be unfair to expose smaller businesses that do not currently have choice in the competitive market to more volatile monthly pricing (AIM Reply Comments at 2). Finally, AIM identifies the need for state agencies to better educate customers regarding their competitive choices (AIM Reply Comments at 2).

ISO-NE's comments describe the process by which it administers the ICAP market, in order to clarify that it is not inconsistent with monthly procurements (ISO-NE Reply Comments at 2). ISO-NE states that it assigns wholesale suppliers' ICAP obligations for the next month ("supply month") on the sixth day of the preceding month (id. at 4). Suppliers are then provided a two-week period in which they can enter into bilateral capacity contracts to meet their ICAP obligations. At the end of this period, ISO-NE conducts a supply auction in where suppliers can submit bids to purchase capacity for the supply month at the auctiondetermined supply auction clearing price. This auction is followed by a second bilateral transaction period. Finally, on or about the 26th day of the month preceding the supply month, ISO-NE conducts a deficiency auction "to ensure that all wholesale suppliers meet their ICAP obligation for the supply month" (id.). ISO-NE states that its "market rules recognize that a lag exists between the assignment of obligations and the supply period, and that a particular wholesale supplier, including default service suppliers, may gain or lose load during that lag period." Suppliers that gain or lose load during the lag period are compensated or charged, as appropriate, at the supply auction clearing price (id. at 6). ISO-NE states that the availability of the supply auction clearing price approximately two weeks before of the supply month allows suppliers to incorporate this price into their bids, thus allowing "just in time" procurement of default service. ISO-NE states "while such a last-minute supplier selection may not be a desirable practice from a market participant perspective, . . . the market rules will readily accommodate 'just-in-time' selection if such a regime is desired form a retail customer perspective" (id. at 6-8).

Finally, WMICG submitted comments in support of an approach in which default service rates would change monthly based on a pre-specified index, while allowing the distribution companies to procure default service supply on a quarterly or semi-annual basis (WMICG Comments at 3-5). WMICG states that its proposed approach would address the logistical issues raised by the distribution companies, while ensuring that default service rates stay aligned with market conditions (id.).

III. ANALYSIS AND FINDINGS

Already significant, the importance of default service in the restructured electric industry will increase as of March 2005 when distribution companies no longer provide standard offer service to their customers. With the end of the transition period now only eighteen months away, it remains essential that the Department take all appropriate steps to ensure that default service is compatible with the development of an efficient competitive market and to ensure that the benefits of a competitive market are available to all Massachusetts consumers. D.T.E. 02-40, at 1.

In D.T.E. 02-40-B at 36-37, the Department identified two ways in which default service may impede the development of a competitive market for medium and large C&I customers. First, because customers know in advance the default service rates for each month of the six-month procurement term, default service provides customers with a level of price certainty that is more appropriately provided by the competitive market. Customers that are satisfied with this level of price certainty will view default service as a viable alternative to competitive supply. As such, customers may not have the appropriate incentive to turn to the competitive market. Id. at 37-39. Second, because default service rates for each month of the six-month procurement term are based on wholesale market conditions at the time of the distribution companies' solicitations (as opposed to market conditions as they exist during each month of the procurement term), default service does not send efficient price signals to customers, particularly during the later months of each procurement term.[9] To the extent that a company's default service prices are at, or below, market prices during a procurement term, a customer evaluating supply options will likely choose default service, deferring a decision on whether to enter into an agreement with a competitive supplier until default service prices for the subsequent six-month procurement term are known. Id.

While the most direct way to resolve the price certainty and price efficiency issues might be to structure default service as a passthrough of the hourly wholesale spot market prices, we have rejected such a model because it would "expose customers to significant risk that spot market prices could skyrocket during certain hours, causing substantial financial harm to customers," thus posing "an unacceptable risk for customers that may appropriately be using default service as a short-term, last resort service." Id. Instead, the Department identified monthly procurement terms as an attractive and feasible approach that would be compatible with the continued development of a competitive market for larger customers because (1) the resulting rates would track wholesale market price on a monthly basis, providing more efficient price signals to customers, (2) the price certainty afforded customers would be limited to one month, and (3) customers would be appropriately protected from spot market price volatility. Id.

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9 To illustrate how default service rates become increasingly disconnected from wholesale market prices as the procurement term progresses, consider an example in which the winning supply bid for the six-month procurement term, July 1 through December 31, is finalized on June 1. Although the default service rates in effect during July will be based on relatively recent market conditions, the rates in effect during December will be based on market conditions that existed six months earlier.

As discussed in Section II.B, above, several commenters recommend that the Department adopt a quarterly procurement approach, stating that quarterly procurements would satisfy the Department's objectives, without requiring the distribution companies and wholesale suppliers to make the significant revisions that would be needed to accommodate monthly procurements. Because default service rates would be realigned with market conditions every three months instead of every six, quarterly procurements should provide improved price signals over those provided by six-month procurements. The combination of more accurate price signals and a decreased period of price certainty should significantly mitigate the anti-competitive effects of customers deferring competitive supply decisions until rates for the subsequent procurement term are known. Because the switch from six-month to quarterly procurements could be accommodated with relative ease by both the distribution companies and wholesale suppliers, such an approach should significantly improve the manner in which default service is procured and priced, while presenting minimal risk to the distribution companies, their customers, and the wholesale market.

Conversely, a move to monthly procurements could entail a substantial amount of risk to the distribution companies, their customers, and wholesale suppliers. As described in Section II.B, above, the default service solicitation processes currently used by distribution companies take longer than one month to complete. To allow for the implementation of monthly procurements, these processes must be compressed into a one-month period in order to avoid the overlapping of solicitations that could cause confusion and create potential inefficiencies for both distribution companies and bidders. To do so, distribution companies would need to develop (1) IT systems to facilitate the increased level of communication between distribution companies and bidders necessary under monthly procurements,[10] and (2) standardized supply contracts and RFPs in order to streamline the solicitation process (in particular that part of the process associated with negotiating final contracts with the winning bidders). Similarly, wholesale suppliers would need to invest significant resources to revise the manner in which they respond to default service RFPs under a monthly procurement approach.

In principle, the implementation of monthly procurements might improve upon the quarterly approach, just as quarterly procurements improve upon the six-month approach. However, the Department does not yet know enough about the effects of a monthly procurement requirement on the electric distribution companies, their systems, their customers, their default providers, and the wholesale market in general. The Department is particularly concerned about the effects that a move to monthly procurements would have on the wholesale market, which in recent months has seen bankruptcy filings by companies that affect approximately 10,000 megawatts of generation resources in New England.

It simply would not be prudent at this time for the Department to mandate a significant change in the retail markets (i.e., a change from the current six-month procurements to monthly procurements) in the face of the current financial uncertainty surrounding the

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10 As stated in Section II, above, these systems must (1) provide access to updated default service-related customer and load data on an ongoing basis to ensure that the bidders have the information necessary to develop their bids, and (2) allow bidders to fully participate in the procurement process electronically.

wholesale markets. The implementation of quarterly procurements is an appropriate, measured near-term step to take as it will allow the electric distribution companies to develop procedures for shorter procurements and assess the behavior of bidders under shorter time periods. Yet, because a shorter procurement period (whether that be bi-monthly or monthly) may, in the longer-term, represent the solution that is most consistent with the Department's objectives of ensuring that default service is compatible with the development of an efficient competitive market for larger customers, the Department will continue to explore it in light of what we learn from the effects of quarterly procurements on the market[11] and the electric distribution companies. Time remains before the March 2005 end of the transition period to judge whether quarterly procurement achieves our goal and, if not, to move to a shorter interval. Based on the discussion above, the Department directs the distribution companies to implement the quarterly procurement of default service supply for their medium and large C&I customers[12] beginning with their upcoming default solicitations.[13]

As stated above, the Department currently has five business days to review the results of each distribution company's solicitation, to ensure that the resulting default service rates are

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11 The market should also benefit from the inclusion of all appropriate costs in default service-rates. See D.T.E. 02-40-B at 14-20.

12 By medium and large C&I customers, the Department means customers taking service under: (1) Fitchburg's G3 rates; (2) MECo's G2 and G3 rates, (3) NSTAR's G2, G3, and T2 rates; and (4) WMECo's G2, T2 and T4 rates. See D.T.E. 02-40-A at 9-10, n.8.

13 MECo's next default service supply procurement term begins November 2003. Fitchburg's next term begins December 2003. NSTAR's and WMECo's next terms begin January 2004.

appropriately market-based and are consistent with other reasonable measures of market activity.[14] See Letter to Massachusetts Electric Company Re: Default Service Solicitation - May 2003 through October 2003 (March 28, 2003) ("March 28th Letter"). The Department concluded that five business days appropriately balanced the need for sufficient time to review the results of a solicitation and the need to minimize the time between when suppliers commit to their bid prices and when the prices are finalized, stating "Department responsiveness is essential to making markets." D.T.E. 99-60-C at 8-9. However, several commenters suggest that a five business day review period is not sufficiently responsive to the dynamic nature of wholesale energy markets.

In the March 28th Letter at 3, the Department approved MECo's proposed default service rates, notwithstanding the fact that they represented "significant increases over its existing rates," in large part because we found MECo's solicitation process to be "open and competitive, consistent with our directives in D.T.E. 99-60-A, 99-60-B, 99-60-C, and 02-40-A, and consistent with the processes followed in the Company's previous solicitations." The most efficient way to ensure that default service rates are market-based is to establish criteria for distribution companies' solicitation processes that will ensure that the solicitations are conducted in an open and competitive manner. By reviewing such criteria prior to a company's solicitation, rather than reviewing the rates that result from the solicitation, the Department can improve the efficiency of the solicitation process and can ensure that our

14 Under the current process, if the Department does not initiate an investigation into the results of the solicitation within five business days, the default service rate proposed by the company is allowed to go into effect. D.T.E. 99-60-C at 8-9.

policies are appropriately responsive to the workings of wholesale markets. Therefore, the Department will look for a way to reduce or eliminate our five-day review period and replace it with other appropriate criteria for review. But any means adopted cannot threaten customer protection. The Department will work with the distribution companies and other interested parties to ensure that the protections currently afforded customers are maintained with any new process of review (see Section IV, below).

Finally, as discussed in Section II.C., above, some commenters identify the Department-mandated 30-day customer notification period as an impediment to the accuracy of price signals sent by default service rates. The price signal that default service rates provide to customers improves as the lag time between when default service supply prices are finalized and the beginning of the supply term decreases. All other things being equal, it would be optimal to finalize default service rates the day before the beginning of the procurement term, as this would best ensure that rates track market prices for the term. When establishing the customer notification requirement, the Department concluded that 30 days struck an appropriate balance between (1) providing customers with sufficient notice of upcoming changes in default service rates, and (2) minimizing the time between when suppliers commit to their bid prices and when the prices take effect. D.T.E. 99-60-C at 2-8. The purpose of a notice period is to provide customers sufficient time to react to upcoming changes in default service rates before they take effect. However, for medium and large C&I customers, a long notice period is inconsistent with the function of default service as a short-term, last resort service for larger customers. Therefore, the Department intends to shorten the 30-day notice period for medium and large C&I customers in order to provide more accurate default service price signals. The Department will work with the distribution companies and other interested parties to develop a shortened notice policy and a schedule to transition from the current 30-day period in order to avoid unnecessary customer confusion (see Section IV, below).

Finally, some commenters assert that ISO-NE's market rules regarding capacity require distribution companies to select their default service suppliers prior to the sixth day of the month preceding the supply term (see Section II.B, above). However, ISO-NE states that its rules could accommodate the selection of suppliers at a later date, using the supply auction clearing price that is often used for supplier that gain or lose load during the month preceding the supply term (see Section II.D, above). We do not have sufficient information to determine how late in the month preceding the supply term it would be reasonable to select default service suppliers and still comply with ISO-NE's ICAP rules. The Department will work with the ISO-NE, the distribution companies, and other interested parties to develop procurement schedules that strike an appropriate balance between providing accurate default service price signals and providing default service suppliers with the appropriate amount of time to fulfill their ICAP responsibilities (see Section IV, below).

IV. WORKING GROUP

In Section III, above, we identify three issues where the Department seeks input from a working group comprised of the distribution companies, ISO-NE, and other interested parties, in order to improve the efficiency of default service solicitations: (1) revisions to the Department's review and approval process; (2) revisions to the current customer notification requirements; and (3) the interaction between the companies' procurement schedules and ISO-NE's ICAP procedures. The Department directs all interested parties to set up a working group, in conjunction with Department staff, to develop recommendations for these matters. The first meeting of the working group will be held on Tuesday, October 7, 2003 at 10:00 a.m. at the Department's offices. The working group should submit to the Department its recommendations for these quarterly procurement standards, protocols, and schedules within 90 days of the issuance of this Order.

V. ORDER

Accordingly, after due consideration, it is

ORDERED: That all electric distribution companies comply with the directives contained in this Order.

By Order of the Department,

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Paul G. Afonso, Chairman

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

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Eugene J. Sullivan, Jr., Commissioner

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Deirdre K. Manning, Commissioner